SUSSEX BANCORP
Form 10-K
March 22, 2010

UNITED STATES
SECURITIES AND EXCHANGE COMMISSION
Washington, D.C. 20549

FORM 10-K

T ANNUAL REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934
For the fiscal year ended December 31, 2009

¨ TRANSITION REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934
For the transition period from ________ to ________

Commission File Number 0-29030

SUSSEX BANCORP
(Exact name of registrant as specified in its charter)

| New Jersey<br>(State or other jurisdiction of incorporation or organization) | 22-3475473<br>(I.R.S. Employer Identification No.) |
|---|---|
| 200 Munsonhurst Rd., Franklin, NJ<br>(Address of principal executive offices) | 07416<br>(Zip Code) |

(973) 827-2914
(Registrant's telephone number, including area code)

Securities Registered Pursuant to Section 12(b) of the Act:

| Common Stock, no par value<br>(Title of each class) | NASDAQ<br>(Name of exchange on which registered) |
|---|---|

Securities registered pursuant to Section 12(g) of the Act: None

Indicate by check mark if the registrant is a well-known seasoned issuer, as defined in Rule 405 of the Securities Act.
Yes ¨ No T

Indicate by check mark if the registrant is not required to file reports pursuant to Section 13 or Section 15(d) of the Act.
Yes ¨ No T

Indicate by check mark whether the registrant (1) has filed all reports required to be filed by Section 13 or 15 (d) of

the Securities Exchange Act of 1934 during the preceding 12 months (or for such shorter period that the registrant was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days.

Yes T No ¨

Indicate by check mark whether the registrant has submitted electronically and posted on its corporate Web site, if any, every Interactive Data File required to be submitted and posted pursuant to Rule 405 of Regulation S-T during the preceding 12 months (or for such shorter period that the registrant was required to submit and post such files).

Yes T No ¨

Indicate by check mark if disclosure of delinquent filers pursuant to Item 405 of Regulation S-K is not contained herein, and will not be contained, to the best of the registrant's knowledge, in definitive proxy or information statements incorporated by reference in Part III of this Form 10-K or any amendment to this Form 10-K. ¨

Indicate by check mark whether the registrant is a large accelerated filer, an accelerated filer, a non-accelerated filer or a smaller reporting company. See the definitions of “large accelerated filer”, “accelerated filer” and “smaller reporting company” in Rule 12b-2 of the Exchange Act.

Large accelerated filer ¨ Accelerated filer ¨ Non-accelerated filer ¨ Smaller reporting company T
(Do not check if a smaller reporting company)

Indicate by check mark whether the registrant is a shell company (as defined in Rule 12b-2 of the Act).

Yes ¨ No T

The aggregate market value of the voting stock held by non-affiliates of the Issuer as of June 30, 2009 was $14,456,470. The number of shares of the Issuer's Common Stock, no par value, outstanding as of March 11, 2010 was 3,317,548.

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PART I

ITEM 1. BUSINESS

GENERAL

Sussex Bancorp (the "Company" or "Registrant") is a one-bank holding company incorporated under the laws of the State of New Jersey in January 1996 to serve as a holding company for Sussex Bank (the "Bank"). The Company was organized at the direction of the Board of Directors of the Bank for the purpose of acquiring all of the capital stock of the Bank (the "Acquisition"). Pursuant to the New Jersey Banking Act of 1948, as amended, (the "Banking Act"), and pursuant to approval of the shareholders of the Bank, the Company acquired the Bank and became its holding company on November 20, 1996. As part of the Acquisition, shareholders of the Bank received one share of common stock, no par value ("Common Stock") of the Company for each outstanding share of the common stock of the Bank, $2.50 per share par value ("Bank Common Stock"). The only significant asset of the Company is its investment in the Bank. The Company's principal executive offices are located at 200 Munsonhurst Road, Route 517, Franklin, Sussex County, New Jersey 07416.

The Bank is a commercial bank formed under the laws of the State of New Jersey in 1975. The Bank operates from its main office at 399 Route 23, Franklin, New Jersey, and its nine branch offices located at 7 Church Street, Vernon, New Jersey; 266 Clove Road, Montague, New Jersey; 33 Main Street, Sparta, New Jersey; 378 Route 23, Wantage, New Jersey; 15 Trinity Street, Newton, New Jersey; 100 Route 206, Augusta, New Jersey; 165 Route 206, Andover, New Jersey; 20-22 Fowler Street, Port Jervis, New York; and 65-67 Main Street, Warwick, New York. On March 24, 2006, the Bank acquired the Port Jervis, New York branch office of NBT Bank, N.A. and expanded its branch network outside of Sussex County New Jersey and into New York State for the first time. The Company received regulatory approval to establish a branch in Westfall Township, Pennsylvania in 2007, although this branch has not yet opened.

On October 1, 2001, the Company acquired all of the outstanding stock of Tri-State Insurance Agency, Inc. (“Tri-State”). Tri-State is a full service insurance agency located in Augusta, New Jersey. Tri-State’s operations are considered a separate segment for financial disclosure purposes.

The Company is subject to the supervision and regulation of the Board of Governors of the Federal Reserve System (the "FRB"). The Bank's deposits are insured by the Deposit Insurance Fund ("DIF") of the Federal Deposit Insurance Corporation ("FDIC") up to applicable limits. The operations of the Company and the Bank are subject to the supervision and regulation of the FRB, FDIC and the New Jersey Department of Banking and Insurance (the "Department"). The operations of Tri-State are also subject to supervision and regulation by Department. The principal executive offices of the Company are located at 200 Munsonhurst Road, Route 517, Franklin, New Jersey 07416, and the telephone number is (973) 827-2914.

The Company has two business segments, banking and financial services and insurance services. For Financial data on the segments see Part II, Item 8, “Financial Statements,” Note 2 of the consolidated financial statements.

BUSINESS OF THE COMPANY

The Company's primary business is ownership and supervision of the Bank and Tri-State, a subsidiary of the Bank. The Company, through the Bank, conducts a traditional commercial banking business, and offers services including personal and business checking accounts and time deposits, money market accounts and regular savings accounts. The Company structures its specific services and charges in a manner designed to attract the business of the small and medium sized business and professional community as well as that of individuals residing, working and shopping in the northwest New Jersey, northeast Pennsylvania and Orange County, New York trade areas. The Company engages in a wide range of lending activities and offers commercial, consumer, mortgage, home equity and

personal loans. The Company is also a party to a joint venture with PNC Mortgage, Inc., called SussexMortgage.com LLC which originates one to four family mortgage loans for funding by third party investors for sale into the secondary market. Servicing is released to the third party investors.

Through the Bank's subsidiary, Tri-State, the Company operates a full service general insurance agency, offering both commercial and personal lines of insurance. The Company considers this to be a separate business segment.

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SERVICE AREA
The Company's service area primarily consists of the Sussex County, New Jersey; Orange County, New York; and Pike County, Pennsylvania markets; although the Company makes loans throughout New Jersey. The Company operates its main office in Franklin, New Jersey and nine branch offices in Vernon, Montague, Sparta, Wantage, Newton, Andover and Augusta, New Jersey and Port Jervis and Warwick, New York. Our market area is among the most affluent in the nation.

COMPETITION
The Company operates in a highly competitive environment competing for deposits and loans with commercial banks, thrifts and other financial institutions, many of which have greater financial resources than the Company. Many large financial institutions in New York City and other parts of New Jersey compete for the business of customers located in the Company's service area. Many of these institutions have significantly higher lending limits than the Company and provide services to their customers which the Company does not offer.

Management believes the Company is able to compete on a substantially equal basis with its competitors because it provides responsive personalized services through management's knowledge and awareness of the Company's service area, customers and business.

PERSONNEL
At December 31, 2009, the Company employed 105 full-time employees and 18 part-time employees. None of these employees are covered by a collective bargaining agreement and the Company believes that its employee relations are good.

REGULATION AND SUPERVISION
Bank holding companies and banks are extensively regulated under both federal and state law. These laws and regulations are intended to protect depositors, not stockholders. Insurance agencies licensed in New Jersey are regulated under state law by the New Jersey Department of Banking and Insurance. To the extent that the following information describes statutory and regulatory provisions, it is qualified in its entirety by reference to the particular statutory and regulatory provisions. Any change in the applicable law or regulation may have a material effect on the business and prospects of the Company and the Bank.

BANK HOLDING COMPANY REGULATION

GENERAL
As a bank holding company registered under the Bank Holding Company Act of 1956, as amended, (the BHCA), we are subject to the regulation and supervision of the Board of Governors of the Federal Reserve System (FRB). We are required to file with the FRB annual reports and other information regarding our business operations and those of our subsidiaries.

The BHCA requires, among other things, the prior approval of the FRB in any case where a bank holding company proposes to (i) acquire all or substantially all of the assets of any other bank, (ii) acquire direct or indirect ownership or control of more than 5% of the outstanding voting stock of any bank (unless it owns a majority of such bank's voting shares) or (iii) merge or consolidate with any other bank holding company. The FRB will not approve any acquisition, merger, or consolidation that would have a substantially anti-competitive effect, unless the anti-competitive impact of the proposed transaction is clearly outweighed by a greater public interest in meeting the convenience and needs of the community to be served. The FRB also considers capital adequacy and other financial and managerial resources and future prospects of the companies and the banks concerned, together with the

convenience and needs of the community to be served when reviewing acquisitions or mergers.

The BHCA also generally prohibits a bank holding company, with certain limited exceptions, from (i) acquiring or retaining direct or indirect ownership or control of more than 5% of the outstanding voting stock of any company which is not a bank or bank holding company; or (ii) engaging directly or indirectly in activities other than those of banking, managing or controlling banks, or performing services for its subsidiaries, unless such non-banking business is determined by the FRB to be so closely related to banking or managing or controlling banks as to be properly incident thereto. In making such determinations, the FRB is required to weigh the expected benefits to the public, such as, greater convenience, increased competition or gains in efficiency, against the possible adverse effects, such as, undue concentration of resources, decreased or unfair competition, conflicts of interest or unsound banking practices.

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In addition, the BHCA was amended through the Gramm-Leach-Bliley Financial Modernization Act of 1999 (the "GLBA"). Under the terms of the GLBA, bank holding companies whose subsidiary banks meet certain capital, management and Community Reinvestment Act standards, and which elect to become "financial holding companies", are permitted to engage in a substantially broader range of non-banking activities than is permissible for bank holding companies under the BHCA. These activities include certain insurance, securities and merchant banking activities. In addition, the GLBA amendments to the BHCA remove the requirement for advance regulatory approval for a variety of activities and acquisitions by financial holding companies. As our business is currently limited to activities permissible for a bank, we have not elected to become a financial holding company.

There are a number of obligations and restrictions imposed on bank holding companies and their depository institution subsidiaries by law and regulatory policy that are designed to minimize potential loss to the depositors of such depository institutions and the FDIC insurance fund in the event the depository institution becomes in danger of default. Under a policy of the FRB with respect to bank holding company operations, a bank holding company is required to serve as a source of financial strength to its subsidiary depository institutions and to commit resources to support such institutions in circumstances where it might not do so absent such policy. The FRB also has the authority under the BHCA to require a bank holding company to terminate any activity or to relinquish control of a non-bank subsidiary upon the FRB's determination that such activity or control constitutes a serious risk to the financial soundness and stability of any bank subsidiary of the bank holding company.

CAPITAL ADEQUACY GUIDELINES FOR BANK HOLDING COMPANIES
The FRB has adopted risk-based capital guidelines for bank holding companies. The risk-based capital guidelines are designed to make regulatory capital requirements more sensitive to differences in risk profile among banks and bank holding companies, to account for off-balance sheet exposure and to minimize disincentives for holding liquid assets. Under these guidelines, assets and off-balance sheet items are assigned to broad risk categories each with appropriate weights. The resulting capital ratios represent capital as a percentage of total risk-weighted assets and off-balance sheet items. The risk-based guidelines apply on a consolidated basis to bank holding companies with consolidated assets of $500 million or more, and to certain bank holding companies with less then $500 million in assets if they are engaged in substantial non-banking activity or meet certain other criteria. We do not meet these criteria, and so are not subject to a minimum consolidated capital requirement. In addition to the risk-based capital guidelines, the FRB has adopted a minimum Tier I capital (leverage) ratio, under which a bank holding company must maintain a minimum level of Tier I capital to average total consolidated assets of at least 3% in the case of a bank holding company that has the highest regulatory examination rating and is not contemplating significant growth or expansion. All other bank holding companies are expected to maintain a leverage ratio of at least 100 to 200 basis points above the stated minimum. The leverage requirement also only applies on a consolidated basis if the risk based capital requirements discussed above apply to a holding company on a consolidated basis. We do not have a minimum consolidated capital requirement at the holding company level at this time.

BANK REGULATION
As a New Jersey-chartered commercial bank, the Bank is subject to the regulation, supervision, and control of the Department. As an FDIC-insured institution, the Bank is subject to regulation, supervision and control of the FDIC, an agency of the federal government. The regulations of the FDIC and the Department impact virtually all activities of the Bank, including the minimum level of capital the Bank must maintain, the ability of the Bank to pay dividends, the ability of the Bank to expand through new branches or acquisitions and various other matters.

INSURANCE OF DEPOSITS
During the third quarter of 2008, Congress instituted the Emergency Economic Stabilization Act (the "EESA") to address the dysfunctional credit markets. Among other things, the Act authorized a temporary increase in the FDIC insurance limit to $250 thousand from $100 thousand per account. The increase in deposit insurance will expire on December 31, 2013. In addition, the FDIC implemented an optional program to insure all deposits held in

noninterest-bearing transactional accounts, regardless of amount, at institutions which do not opt out of the program and which pay an additional assessment to the FDIC. The Bank elected not to opt out of this program, and is paying the required additional assessment. This increase in deposit insurance will expire on June 30, 2010. If either of these programs is not extended, the prior limits described below, will go back into effect.

Prior to the fall of 2008, the Bank's deposits were insured up to a maximum of $100 thousand per depositor ($250 thousand per IRA account) under the Deposit Insurance Fund of the FDIC. Pursuant to the Federal Deposit Insurance Corporation Improvements Act of 1991 ("FDICIA"), the FDIC has established a risk-based assessment system. Premium assessments under this system are based upon: (i) the probability that the insurance fund will incur a loss with respect to the institution; (ii) the likely amount of the loss; and (iii) the revenue needs of the

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insurance fund. To effectuate this system, the FDIC has developed a matrix that sets the assessment premium for a particular institution in accordance with its capital level and overall rating by the primary regulator.

The FDIC significantly increased deposit insurance assessment rates, commencing in the second quarter of 2009. As increased, the adjusted base assessment rates range from 7 to 77.5 basis points of deposits, a significant increase over premium rates for the past several years. In addition, the Bank will pay a special assessment of 10 basis points of the amount of deposits in excess of $250,000 held in non-interest bearing transactional accounts under the enhanced insurance program discussed above.

The FDIC also imposed a special assessment during 2009 equal to the lesser of 10 basis points on deposits or 5 basis points on total assets less Tier I capital. The Company paid $211,411 on September 30, 2009 on adjusted assets as of June 30, 2009. Finally, the FDIC Board adopted a prepaid assessment plan to recapitalize the Deposit Insurance Fund (DIF) by requiring all institutions to prepay their estimated risk-based assessments for the fourth quarter of 2009 and for all of 2010, 2011 and 2012 on December 30, 2009. The Company's prepaid assessment was $3.1 million. This assessment will be expensed by the Company over the period the premiums would otherwise have been paid.

DIVIDEND RIGHTS

Under the Banking Act, a Bank may declare and pay dividends only if, after payment of the dividend, the capital stock of the Bank will be unimpaired and either the Bank will have a surplus of not less than 50% of its capital stock or the payment of the dividend will not reduce the Bank's surplus.

LEGISLATIVE AND REGULATORY CHANGES

On October 8, 2008, the Emergency Economic Stabilization Act (the "EESA") was signed into law. Among other things, the EESA provided for the United States Treasury (the "UST") to implement the Troubled Assets Relief Program ("TARP") Capital Purchase Program ("CPP"). Under the CPP, the UST purchased shares of senior preferred stock in insured depository institutions or their holding companies, bearing a dividend rate of 5%, increasing to 9% if the preferred stock is not redeemed within five (5) years of the issue date. In addition, participating institutions must issue to the UST common stock purchase warrants, permitting the UST to purchase common stock with a value equal to 15% of the UST's preferred stock investment, and comply with reporting requirements, compensation restrictions and dividend and stock repurchase limitations imposed under the EESA and UST regulations. The Company elected not to participate in the CPP.

On February 16, 2009, the American Recovery and Reinvestment Act of 2009 (the "ARRA") was adopted. Among other things, the ARRA amended various provisions of the EESA to, among other things, substantially restrict executive compensation for those entities that participate in the CPP, including those institutions that participated prior to the adoption of the ARRA, impose more stringent reporting requirements on such institutions and requires such institutions to permit their shareholders to have a non-binding, advisory vote on executive compensation.

On July 30, 2002, the Sarbanes-Oxley Act, or "SOX" was enacted. SOX is not a banking law, but applies to all public companies, including Sussex Bancorp. The stated goals of SOX are to increase corporate responsibility, to provide for enhanced penalties for accounting and auditing improprieties at publicly traded companies and to protect investors by improving the accuracy and reliability of corporate disclosures pursuant to the securities laws. SOX is the most far reaching U.S. securities legislation enacted in some time. SOX generally applies to all companies, both U.S. and non-U.S., that file or are required to file periodic reports with the Securities and Exchange Commission (the "SEC") under the Securities Exchange Act of 1934, as amended.

SOX includes very specific additional disclosure requirements and corporate government rules and requires the SEC and securities exchanges to adopt extensive additional disclosure, corporate governance and other related rules and mandates further studies of specific issues by the SEC. SOX represents significant federal involvement in matters

traditionally left to state regulatory systems, such as the regulation of the accounting profession, and to state corporate law, such as the relationship between a board of directors and management and between a board of directors and its committees. SOX addresses, among other matters:

- audit committees;
- certification of financial statements by the chief executive officer and the chief financial officer;
- management's assessment of a company's internal controls over financial reporting, and a company's auditor's certification of such assessment;

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- the forfeiture of bonuses or other incentive-based compensation and profits from the sale of an issuer's securities by directors and senior officers in the twelve month period following initial publication of any financial statements that later require restatement;
- a prohibition on insider trading during pension plan black out periods;
- disclosure of off-balance sheet transactions;
- a prohibition on personal loans to officers and directors, unless subject to Federal Reserve Regulation O;
- expedited filing requirements for Form 4 statements of changes of beneficial ownership of securities required to be filed by officers, directors and 10% shareholders;
- disclosure of whether or not a company has adopted a code of ethics;
- "real time" filing of periodic reports;
- auditor independence; and
- various increased criminal penalties for violations of securities laws.

Complying with the requirements of SOX as implemented by the SEC has and will continue to increase our compliance costs and could make it more difficult to attract and retain board members.

On October 26, 2001, a new anti-terrorism bill, the International Money Laundering Abatement and Anti-Terrorism Funding Act of 2001, was signed into law. This law restricts money laundering by terrorists in the United States and abroad. This act specifies new "know your customer" requirements that obligate financial institutions to take actions to verify the identity of the account holders in connection with opening an account at any U.S. financial institution. Banking regulators will consider compliance with the act's money laundering provisions in making decisions regarding approval of acquisitions and mergers. In addition, sanctions for violations of the act can be imposed in an amount equal to twice the sum involved in the violating transaction, up to $1 million.

## ITEM 1A. RISK FACTORS

Risks affecting Our Business:
The nationwide recession may adversely affect our business by reducing real estate values in our trade area and stressing the ability of our customers to repay their loans. Our trade area, like the rest of the United States, is currently experiencing economic contraction. As a result, many companies have experienced reduced revenues and have laid off employees. These factors have stressed the ability on both commercial and consumer customers to repay their loans, and have, and may in the future, result in higher levels of non-accrual loans. In addition, real estate values have declined in our trade area. Since the majority of our loans are secured by real estate, declines in the market value of real estate impact the value of the collateral securing our loans, and could lead to greater losses in the event of defaults on loans secured by real estate.

Our non-performing assets have substantially increased over the past two years, and this has, and will continue, to affect our results of operations. Since year end 2007, our total non-performing assets have increased to $24.3 million, or 5.33% of our total assets, from $14.0 million, or 3.56% of our total assets. The increase in non-performing assets reflects difficulties experienced by borrowers due to declining real estate values and the general slowdown in the economy in our trade area. The increase in non-performing assets has negatively impacted our results of operations, through additional provisions for loan losses and reduced interest income, and will continue to impact our performance until these assets are resolved. In addition, future increases in our non-performing assets will further negatively affect our results of operations. We can give you no assurance that our non-performing assets will not increase further.

Our FDIC deposit insurance premiums have increased and may continue to increase, substantially increasing our non-interest expense. During 2008 and 2009, the FDIC has significantly increased its assessments for deposit

insurance due to the weakness in the economy and the increased number of bank failures. In 2008, we paid $385 thousand in deposit insurance assessments and in 2009 this increased to $936 thousand. The FDIC increased its assessment in the second quarter of 2009, which raised insurance premiums for the healthiest banks by 7 basis points, with the new assessments ranging from 12 to 77.5 basis points. Banks that have opted to remain eligible for the FDIC's increased insurance program for non-interest bearing deposit must also pay an assessment of 10 basis points of the amount of non-interest bearing deposits in excess of $250,000. The FDIC also imposed a special assessment of the lessor of 5 basis points of total assets minus Tier I capital or 10 basis points of insured deposits as of June 30, 2009, paid on September 30, 2009. This special assessment totaled $211,411. In addition on December 31, 2009 a prepaid assessment of $3.1 million was paid to the FDIC to cover future assessments through December of 2012. These additional costs will adversely affect our results of operations.



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Our earnings may not grow if we are unable to successfully attract core deposits and lending opportunities and exploit opportunities to generate fee-based income. We have experienced growth, and our future business strategy is to continue to expand. Historically, the growth of our loans and deposits has been the principal factor in our increase in net-interest income. In the event that we are unable to execute our business strategy of continued growth in loans and deposits, our earnings could be adversely impacted. Our ability to continue to grow depends, in part, upon our ability to expand our market share, to successfully attract core deposits and identify loan and investment opportunities, as well as opportunities to generate fee-based income. Our ability to manage growth successfully will also depend on whether we can continue to efficiently fund asset growth and maintain asset quality and cost controls, as well as on factors beyond our control, such as economic conditions and interest-rate trends.

Our growth-oriented business strategy could be adversely affected if we are not able to attract and retain skilled employees and manage our expenses. We expect to continue to experience growth in the scope of our operations and, correspondingly, in the number of our employees and customers. We may not be able to successfully manage our business as a result of the strain on our management and operations that may result from this growth. Our ability to manage this growth will depend upon our ability to continue to attract, hire and retain skilled employees. Our success will also depend on the ability of our officers and key employees to continue to implement and improve our operational and other systems, to manage multiple, concurrent customer relationships and to hire, train and manage our employees.

Market conditions may adversely affect our fee based insurance business. The revenues of our fee based insurance business are derived primarily from commissions from the sale of insurance policies, which commissions are generally calculated as a percentage of the policy premium. These insurance policy commissions can fluctuate as insurance carriers from time to time increase or decrease the premiums on the insurance products we sell.

Risks Related to the Banking Industry:

Changes in local economic conditions could adversely affect our loan portfolio. Our success depends to a great extent upon the general economic conditions of the local markets that we serve. Unlike larger banks that are more geographically diversified, we provide banking and financial services primarily to customers in the three counties in the New Jersey, Pennsylvania and New York markets in which we have branches, so any decline in the economy of this specific region could have an adverse impact on us.

Our loans, the ability of borrowers to repay these loans and the value of collateral securing these loans, are impacted by economic conditions. Our financial results, the credit quality of our existing loan portfolio, and the ability to generate new loans with acceptable yield and credit characteristics may be adversely affected by changes in prevailing economic conditions, including declines in real estate values, changes in interest rates, adverse employment conditions and the monetary and fiscal policies of the federal government. We cannot assure you that continued negative trends or developments will not have a significant adverse effect on us.

There is a risk that we may not be repaid in a timely manner, or at all, for loans we make. The risk of non-payment (or deferred or delayed payment) of loans is inherent in commercial banking. Such non-payment, or delayed or deferred payment of loans to the Company, if they occur, may have a material adverse effect on our earnings and overall financial condition. Additionally, in compliance with applicable banking laws and regulations, the Company maintains an allowance for loan losses created through charges against earnings. As of December 31, 2009, the Company’s allowance for loan losses was $5.5 million. The Company’s marketing focus on small to medium-size businesses may result in the assumption by the Company of certain lending risks that are different from or greater than those which would apply to loans made to larger companies. We seek to minimize our credit risk exposure through credit controls, which include evaluation of potential borrowers’ available collateral, liquidity and cash flow. However, there can be no assurance that such procedures will actually reduce loan losses.

Our allowance for loan losses may not be adequate to cover actual losses. Like all financial institutions, we maintain an allowance for loan losses to provide for loan defaults and nonperformance. Our allowance for loan losses may not be adequate to cover actual losses, and future provisions for loan losses could materially and adversely affect the results of our operations. Risks within the loan portfolio are analyzed on a continuous basis by management and, periodically, by an independent loan review function and by the Audit Committee. A risk system, consisting of multiple-grading categories, is utilized as an analytical tool to assess risk and the appropriate level of loss reserves. Along with the risk system, management further evaluates risk characteristics of the loan portfolio under current economic conditions and considers such factors as the financial condition of the borrowers, past and expected loan loss experience and other factors management feels deserve recognition in establishing an adequate reserve. This risk assessment process is performed at least quarterly and as adjustments become necessary, they are realized in the periods in which they become known. The amount of future losses is susceptible to changes in economic, operating and other conditions, including changes in interest rates that may be beyond our control, and

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these losses may exceed current estimates. State and federal regulatory agencies, as an integral part of their examination process, review our loans and allowance for loan losses and have in the past required an increase in our allowance for loan losses. Although we believe that our allowance for loan losses is adequate to cover probable and reasonably estimated losses, we cannot assure you that we will not further increase the allowance for loan losses or that our regulators will not require us to increase this allowance. Either of these occurrences could adversely affect our earnings.

We are in competition with many other financial service providers, including larger commercial banks which have greater resources than us. The banking industry within our trade area is highly competitive. The Company’s principal market area is also served by branch offices of large commercial banks and thrift institutions. In addition, in 1999 the Gramm-Leach-Bliley Financial Modernization Act of 1999 was passed into law. The Modernization Act permits other financial entities, such as insurance companies and securities firms, to acquire or form financial institutions, thereby further increasing competition. A number of our competitors have substantially greater resources than we do to expend upon advertising and marketing, and their substantially greater capitalization enables them to make much larger loans. Our success depends upon our ability to serve small business clients in a more responsive manner than the large and mid-size financial institutions against whom we compete in our principal market area. In addition to competition from larger institutions, we also face competition for individuals and small businesses from recently-formed banks seeking to compete as “home town” institutions. Most of these new institutions have focused their marketing efforts on the smaller end of the small business market we serve.

The laws that regulate our operations are designed for the protection of depositors and the public, but not our stockholders. The federal and state laws and regulations applicable to our operations give regulatory authorities extensive discretion in connection with their supervisory and enforcement responsibilities and generally have been promulgated to protect depositors and the deposit insurance funds and to foster economic growth and not for the purpose of protecting stockholders. These laws and regulations can materially affect our future business. Laws and regulations now affecting us may be changed at any time, and the interpretation of such laws and regulations by bank regulatory authorities is also subject to change. We can give no assurance that future changes in laws and regulations or changes in their interpretation will not adversely affect our business.

We may be subject to higher operating costs as a result of government regulation. We are subject to extensive federal and state legislation, regulation and supervision which are intended primarily to protect depositors and the Federal Deposit Insurance Company's Deposit Insurance Fund, rather than investors. Legislative and regulatory changes may increase our costs of doing business; or, otherwise, adversely affect us and create competitive advantages for non-bank competitors.

We cannot predict how changes in technology will impact our business. The financial services market, including banking services, is increasingly affected by advances in technology, including developments in:

- telecommunications;
- data processing;
- automation;
- internet-based banking;
- tele-banking; and
- debit cards and so-called "smart cards."

Our ability to compete successfully in the future will depend on whether we can anticipate and respond to technological changes. To develop these and other new technologies, we will likely have to make additional capital investments. Although we continually invest in new technology, we cannot assure you that we will have sufficient resources or access to the necessary proprietary technology to remain competitive in the future.

The Company's information systems may experience an interruption or breach in security. The Company relies heavily on communications and information systems to conduct its business. Any failure, interruption or breach in security of these systems could result in failures or disruptions in the Company's customer-relationship management, general ledger, deposit, loan and other systems. While the Company has policies and procedures designed to prevent or limit the effect of the failure, interruption or security breach of its information systems, there can be no assurance that any such failures, interruptions or security breaches will not occur; or, if they do occur, that they will be adequately addressed. The occurrence of any failures, interruptions or security breaches of the Company's information systems could damage the Company's reputation, result in a loss of customer business, subject the Company to additional regulatory scrutiny or expose the Company to civil litigation and possible financial liability; any of which could have a material adverse affect on the Company's financial condition and results of operations.



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ITEM 1B. UNRESOLVED STAFF COMMENTS

None

ITEM 2. PROPERTIES

The Company conducts its business through its principal executive office located at 200 Munsonhurst Road, Route 517, Franklin, New Jersey, its ten banking offices, and its insurance agency office. The following table sets forth certain information regarding the Company's properties as of December 31, 2009. All properties are adequately covered by insurance.

| LOCATION | LEASED OR OWNED | DATE OF LEASE EXPIRATION |
|---|---|---|
| 399 Route 23 Franklin, New Jersey | Owned | N/A |
| 7 Church Street Vernon, New Jersey | Owned | N/A |
| 266 Clove Road Montague, New Jersey | Leased | March, 2012 |
| 96 Route 206 Augusta, New Jersey | Leased | July, 2015 |
| 378 Route 23 Wantage, New Jersey | Owned | N/A |
| 455 Route 23 Wantage, New Jersey | Owned (1) | N/A |
| 15 Trinity Street Newton, New Jersey | Owned | N/A |
| 165 Route 206 Andover, New Jersey | Owned | N/A |
| 100 Route 206 Augusta, New Jersey | Owned | N/A |
| 33 Main Street Sparta, New Jersey | Owned | N/A |
| | Leased | December, 2013 |

| | | |
|---|---|---|
| 200 Munsonhurst Road Franklin, New Jersey | | |
| 20-22 Fowler Street Port Jervis, New York | Leased | June, 2016 |
| 65-67 Main Street Warwick, New York | Leased | December, 2011 |

(1) The Company owns the building housing its former Wantage branch. The land on which the building is located is leased pursuant to a ground lease which runs until December 31, 2020, and contains an option for the Company to extend the lease for an additional 25 year term.

ITEM 3. LEGAL PROCEEDINGS

The Company and the Bank are periodically involved in various legal proceedings as a normal incident to their businesses. In the opinion of management no material loss is expected from any such pending lawsuit.

ITEM 4. SUBMISSIONS OF MATTERS TO A VOTE OF SECURITY HOLDERS

No matters were submitted for a vote of the registrant's shareholders during the fourth quarter of fiscal 2009.

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PART II

ITEM 5. MARKET FOR REGISTRANT'S COMMON EQUITY AND RELATED STOCKHOLDER MATTERS

The Company's Common Stock trades on the NASDAQ Global Market, under the symbol "SBBX". As of December 31, 2009, the Company had approximately 613 holders of record of its common stock.

The following table shows the high and low sales price, by quarter, for the common stock, as well as dividends declared, for the last two fiscal years, as adjusted for the 6.5% stock dividend paid on November 12, 2008:

| 2009 | High Sales Price: | Low Sales Price: | Dividends Declared: |
|---|---|---|---|
| 4th Quarter | $5.15 | $3.24 | $0.000 |
| 3rd Quarter | $5.74 | $3.00 | $0.000 |
| 2nd Quarter | $5.35 | $3.50 | $0.000 |
| 1st Quarter | $5.87 | $1.99 | $0.030 |

| 2008 | High Sales Price: | Low Sales Price: | Dividends Declared: |
|---|---|---|---|
| 4th Quarter | $8.75 | $3.50 | $0.000 |
| 3rd Quarter | $9.50 | $6.93 | $0.065 |
| 2nd Quarter | $13.00 | $8.01 | $0.065 |
| 1st Quarter | $12.89 | $9.74 | $0.065 |

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ITEM 6. SELECTED FINANCIAL DATA

The following selected financial data as of December 31 for each of the five years should be read in conjunction with the Company's audited consolidated financial statements and the accompanying notes.

| | As of and for the Year Ended December 31, | | | | |
|---|---|---|---|---|---|
| (Dollars in thousands, except per share data)) | 2009 | 2008 | 2007 | 2006 | 2005 |
| SUMMARY OF INCOME: | | | | | |
| Interest income | $23,055 | $22,653 | $22,808 | $19,998 | $15,547 |
| Interest expense | 8,053 | 10,843 | 11,387 | 8,249 | 4,328 |
| Net interest income | 15,002 | 11,810 | 11,421 | 11,749 | 11,219 |
| Provision for loan losses | 3,404 | 1,350 | 1,930 | 733 | 1,138 |
| Net interest income after provision for loan losses | 11,598 | 10,460 | 9,491 | 11,016 | 10,081 |
| Other income | 5,544 | 1,991 | 5,616 | 5,244 | 4,873 |
| Other expenses | 14,679 | 14,589 | 13,148 | 12,648 | 11,603 |
| Income (loss) before income tax expense (benefit) | 2,463 | (2,138) | 1,959 | 3,612 | 3,351 |
| Income tax expense (benefit) | 452 | (1,096) | 450 | 1,148 | 952 |
| Net income (loss) | $2,011 | $(1,042) | $1,509 | $2,464 | $2,399 |
| | | | | | |
| WEIGHTED AVERAGE NUMBER OF SHARES: (1) | | | | | |
| Basic | 3,247,723 | 3,291,710 | 3,354,828 | 3,359,529 | 3,368,788 |
| Diluted | 3,258,549 | 3,291,710 | 3,385,052 | 3,395,880 | 3,408,933 |
| | | | | | |
| PER SHARE DATA: | | | | | |
| Basic earnings (loss) per share | $0.62 | $(0.32) | $0.45 | $0.73 | $0.71 |
| Diluted earnings (loss) per share | 0.62 | (0.32) | 0.45 | 0.73 | 0.70 |
| Cash dividends (2) | 0.03 | 0.20 | 0.26 | 0.26 | 0.19 |
| Stock dividends | 0.0% | 6.5% | 0.0% | 0.0% | 5.0% |
| | | | | | |
| BALANCE SHEET: | | | | | |
| Loans, net | $327,463 | $315,067 | $295,506 | $258,936 | $208,720 |
| Total assets | 454,841 | 440,595 | 393,532 | 356,297 | 313,182 |
| Total deposits | 372,075 | 360,081 | 308,538 | 295,770 | 256,847 |
| Total stockholders’ equity | 34,527 | 31,910 | 34,440 | 34,592 | 32,924 |
| Average assets | 463,616 | 419,725 | 379,155 | 332,912 | 291,368 |
| Average stockholders’ equity | 33,390 | 33,699 | 35,046 | 33,710 | 32,368 |
| | | | | | |
| PERFORMANCE RATIOS: | | | | | |
| Return on average assets | 0.43% | -0.25% | 0.40% | 0.74% | 0.82% |
| Return on average stockholders’ equity | 6.02% | -3.09% | 4.31% | 7.31% | 7.41% |
| Average equity/average assets | 7.20% | 8.03% | 9.24% | 10.13% | 11.11% |
| Net interest margin | 3.60% | 3.12% | 3.31% | 3.91% | 4.34% |
| Efficiency ratio (3) | 71.44% | 105.71% | 77.17% | 74.43% | 72.10% |
| Other income to net interest income plus other income | 26.98% | 14.43% | 32.96% | 30.86% | 30.28% |

| | | | | | | | | | | |
|---|---|---|---|---|---|---|---|---|---|---|
| Dividend payout ratio | 5 | % | -63 | % | 58 | % | 36 | % | 26 | % |
| | | | | | | | | | | |
| BANK CAPITAL RATIOS: (4) | | | | | | | | | | |
| Tier I capital to average assets | 9.07 | % | 8.59 | % | 7.72 | % | 8.54 | % | 9.23 | % |
| Tier I capital to total risk-weighted assets | 11.91 | % | 11.04 | % | 9.66 | % | 10.46 | % | 12.40 | % |
| Total capital to total risk-weighted assets | 13.17 | % | 12.29 | % | 10.91 | % | 11.63 | % | 13.55 | % |
| | | | | | | | | | | |
| ASSET QUALITY RATIOS: | | | | | | | | | | |
| Non-performing loans to total gross loans | 6.13 | % | 3.44 | % | 4.28 | % | 1.01 | % | 0.65 | % |
| Non-performing assets to total assets | 5.33 | % | 3.41 | % | 3.35 | % | 0.75 | % | 0.44 | % |
| Net loan charge-offs to average total loans | 1.14 | % | 0.22 | % | 0.05 | % | 0.00 | % | 0.43 | % |
| Allowance for loan losses to total gross loans at period end | 1.65 | % | 1.81 | % | 1.71 | % | 1.27 | % | 1.24 | % |
| Allowance for loan losses to non-performing loans (5) | 26.92 | % | 52.62 | % | 39.96 | % | 125.61 | % | 190.04 | % |

(1) The weighted average number of shares outstanding was computed based on the average number of shares outstanding during each period as adjusted for subsequent stock dividends.

(2) Cash dividends per common share are based on the actual number of common shares outstanding on the dates of record as adjusted for subsequent stock dividends.

(3) Efficiency ratio is total other expenses divided by net interest income and total other income.

(4) As the Company has consolidated assets of less than $500 million, it does not have a minimum consolidated requirement. The ratios presented are those of the Bank.

(5) Non-performing loans includes non-accrual loans, loans past due 90 days and still accruing and restructured loans not on non-accrual.

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ITEM 7. MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS

GENERAL

This discussion is intended to assist in understanding the financial condition and results of operations of the Company. This discussion should be read in conjunction with the Consolidated Financial Statements and accompanying Notes contained in this report.

MANAGEMENT STRATEGY

The Company's goal is to serve as a community-oriented financial institution serving the northwestern New Jersey, northeastern Pennsylvania and Orange County, New York marketplace. While offering traditional community bank loan and deposit products and services, the Company obtains significant non-interest income through its Tri-State Insurance Agency, Inc. ("Tri-State"), insurance brokerage operations and the sale of non-deposit products. We report the operations of Tri-State as a separate segment from our commercial banking operations. See Note 2 to the Consolidated Financial Statements for December 31, 2009 included herein for more financial data regarding our two segments.

FORWARD LOOKING STATEMENTS

When used in this discussion the words: “believes”, “anticipates”, “contemplated”, “expects” or similar expressions are intended to identify forward looking statements. Such statements are subject to certain risks and uncertainties that could cause actual results to differ materially from those projected. Those risks and uncertainties include those discussed under Item 1A – “Risk Factors” of this Annual Report on Form 10-K and to the following: changes to interest rates, the ability to control costs and expenses, the Company’s ability to integrate new technology into its operations, general economic conditions, the success of the Company’s efforts to diversify its revenue base by developing additional sources of non-interest income while continuing to manage its existing fee based business, the impact of changing statutory and regulatory requirements on the Company and the risks inherent in integrating acquisitions into the Company and commencing operations in new markets. The Company undertakes no obligation to publicly release the results of any revisions to those forward looking statements that may be made to reflect events or circumstances after this date or to reflect the occurrence of unanticipated events.

CRITICAL ACCOUNTING POLICIES

Our accounting policies are fundamental to understanding Management's Discussion and Analysis of Financial Condition and Results of Operations. Our accounting policies are more fully described in Note 1 of the Notes to the Consolidated Financial Statements for December 31, 2009 included herein. The preparation of financial statements in conformity with generally accepted accounting principles requires management to make estimates and assumptions about future events that affect the amounts reported in our Consolidated Financial Statements and accompanying Notes. Since future events and their effect cannot be determined with absolute certainty, actual results may differ from those estimates. Management makes adjustments to its assumptions and judgments when facts and circumstances dictate. The amounts currently estimated by us are subject to change if different assumptions as to the outcome of future events were made. We evaluate our estimates and judgments on historical experience and on various other factors that are believed to be reasonable under the circumstances. Management believes the following critical accounting policies encompass the more significant judgments and estimates used in preparation of our consolidated financial statements.

Allowance for Loan Losses. The provision for loan losses charged to operating expense reflects the amount deemed appropriate by management to provide for known and inherent losses in the existing loan portfolio. Management's judgment is based on the evaluation of the past experience of individual loans, the assessment of current economic conditions, and other relevant factors. Loan losses are charged directly against the allowance for loan losses and recoveries on previously charged-off loans are added to the allowance. Management uses significant estimates to

determine the allowance for loan losses. Consideration is given to a variety of factors in establishing these estimates including current economic conditions, diversification of the loan portfolio, delinquency statistics, borrowers' perceived financial and managerial strengths, the adequacy of underlying collateral, if collateral dependent, or present value of future cash flows, and other relevant factors. Since the sufficiency of the allowance for loan losses is dependent to a great extent on conditions that may be beyond our control, it is possible that management's estimates of the allowance for loan losses and actual results could differ in the near term. Although we believe that we use the best information available to establish the allowance for loan losses, future additions to the allowance may be necessary if certain future events occur that cause actual results to differ from the assumptions used in making the evaluation. For example, a downturn in the local economy could cause increases in non-performing loans. Additionally, a decline in real estate values could cause some of our loans to become inadequately collateralized. In either case, this may require us to increase our provisions for loan losses, which would negatively

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impact earnings. Additionally, a large loss could deplete the allowance and require increased provisions to replenish the allowance, which would negatively impact earnings. Finally, regulatory authorities, as an integral part of their examination, periodically review the allowance for loan losses. They may require additions to the allowance for loan losses based upon their judgments about information available to them at the time of examination. Future increases to our allowance for loan losses, whether due to unexpected changes in economic conditions or otherwise, could adversely affect our future results of operations.

Stock Compensation Plans. The Company currently has several stock plans in place for employees and directors of the Company. The Company accounts for stock-based compensation under the accounting guidance of FASB ASC 718, Compensation-Stock Compensation, which requires that the compensation cost relating to share-based payment transactions be recognized in financial statements. The stock compensation accounting guidance requires that compensation cost for all stock awards be calculated and recognized over predefined vesting periods.

Income Taxes. Management considers accounting for income taxes as a critical accounting policy due to the subjective nature of certain estimates that are involved in the calculation and evaluation of the timing and recognition of resulting tax assets and liabilities. Management uses the asset liability method of accounting for income taxes in which deferred tax assets and liabilities are established for the temporary differences between the financial reporting basis and the tax basis of the Company’s assets and liabilities. Deferred tax expense is the result of changes between deferred tax assets and liabilities. The principal types of differences between assets and liabilities for financial statement and tax return purposes are allowance for loan losses, deferred compensation and securities available for sale.

Goodwill and Other Intangible Assets. The Company has recorded goodwill of $2.8 million at December 31, 2009 primarily related to the acquisition of Tri-State Insurance Agency in October of 2001. FASB ASC 350, Intangibles-Goodwill and Others, requires that goodwill is not amortized to expense, but rather that it be tested for impairment at least annually. The Company periodically assesses whether events or changes in circumstances indicate that the carrying amounts of goodwill require additional impairment testing. The Company performs its annual impairment test on the goodwill of Tri-State in the fourth quarter of each calendar year. If the fair value of the reporting unit exceeds the book value, no write-downs of goodwill are necessary. If the fair value is less than the book value, an additional test is necessary to assess the proper carrying value of goodwill. The Company determined that no impairment write-offs were necessary during 2009 and 2008.

Business unit valuation is inherently subjective, with a number of factors based on assumptions and management judgments. Among these are future growth rates, discount rates and earnings capitalization rates. Changes in assumptions and results due to economic conditions, industry factors and reporting unit performance could result in different assessments of the fair value and could result in impairment charges in the future.

Investment Securities Impairment Evaluation. Management evaluates securities for other-than-temporary impairment on at least a quarterly basis, and more frequently when economic or market concerns warrant such evaluation. Consideration is given to (1) the length of time and the extent to which the fair value has been less than cost, (2) the financial condition and near-term prospects of the issuer, and (3) if the Company does not intend to sell the security, and it is more likely than not that the Company will not have to sell the security before recovery of its cost basis, it will recognize the credit component of an other-than–temporary impairment of the security in earnings and the remaining portion in other comprehensive income. For held to maturity securities, the amount of an other-than-temporary impairment recorded in other comprehensive income for the noncredit portion of a previous other-then-temporary impairment should be amortized prospectively over the remaining life of the security on the basis of the timing of future estimated cash flows of the security. The Company did not have any held for maturity securities in 2009 and 2008. The Company did not recognize an other-than-temporary impairment charge in 2009 and did record a $3.5 million other-than-temporary impairment in 2008.

COMPARISION OF OPERATING RESULTS AT YEAR-END DECEMBER 31, 2009 and 2008

Overview. Total assets were $454.8 million at year-end 2009 compared to $440.6 million at year-end 2008, an increase of $14.2 million, or 3.2%. Total loans, net of the allowance for loan losses, increased $12.4 million, or 3.9%, to $327.5 million at December 31, 2009 from $315.1 million at December 31, 2008. Total deposits increased by $12.0 million, or 3.3% to $372.1 million at December 31, 2009 from $360.1 million at December 31, 2008. The increase in the Company's balance sheet was driven by core deposit growth, which funded the increases in loan receivable balances.



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Results of Operations. For the year ended December 31, 2009, the Company returned to profitability, earning net income of $2.0 million compared to a net loss of $1.0 million for prior year. Basic and diluted earnings per share were $0.62 for the year ended December 31, 2009 compared to basic and diluted loss per share of ($0.32) for the same period last year. For the year ended December 31, 2009 the Company had 3,247,723 average basic shares outstanding, compared to 3,291,710 average basic shares for the year ended December 31, 2008, as adjusted for the 6.5% stock dividend.

The Company's results are primarily attributable to the increase in the net interest income of $3.2 million and the absence of the $3.5 million other-than-temporary impairment charge recognized by the Company in 2008 related to certain Fannie Mae and Freddie Mac securities held by the Company, offset by a $2.0 million increase to the provision for loan losses. The Company's net interest margin increased 48 basis points to 3.60% in 2009 from 3.12% in 2008, while its net interest spread (i.e., the difference between the average yield on the Company's interest earning assets and the average rate on its interest bearing liabilities) increased 66 basis points to 3.39% in 2009 from 2.73% in 2008. These changes reflect reductions in the yield on the Company's earning assets being more than offset by reductions in the cost of the Company's liabilities in a declining rate environment.

Comparative Average Balance and Average Interest Rates

The following table presents, on a fully taxable equivalent basis, a summary of the Company's interest-earning assets and their average yields, and interest-bearing liabilities and their average costs for each of the years ended December 31, 2009 and 2008. The average balances of loans include non-accrual loans, and associated yields include loan fees, which are considered adjustment to yields.

| | Twelve Months Ended December 31, | | | | | |
|---|---|---|---|---|---|---|
| (Dollars in thousands) | 2009 | | | 2008 | | |
| Earning Assets: | Average Balance | Interest (1) | Average Rate (2) | Average Balance | Interest (1) | Average Rate (2) |
| Securities: | | | | | | |
| Tax exempt (3) | $28,102 | $1,747 | 6.22 % | $23,720 | $1,458 | 6.15 % |
| Taxable | 59,035 | 2,587 | 4.38 % | 47,234 | 2,266 | 4.80 % |
| Total securities | 87,137 | 4,334 | 4.97 % | 70,954 | 3,724 | 5.25 % |
| Total loans receivable (4) | 326,740 | 19,259 | 5.89 % | 307,845 | 19,150 | 6.22 % |
| Other interest-earning assets | 19,208 | 45 | 0.23 % | 14,749 | 261 | 1.77 % |
| Total earning assets | 433,085 | $23,638 | 5.46 % | 393,548 | $23,135 | 5.88 % |
| | | | | | | |
| Non-interest earning assets | 36,355 | | | 31,359 | | |
| Allowance for loan losses | (5,824) | | | (5,182) | | |
| Total Assets | $463,616 | | | $419,725 | | |
| | | | | | | |
| Sources of Funds: | | | | | | |
| Interest bearing deposits: | | | | | | |
| NOW | $57,928 | $582 | 1.00 % | $58,878 | $798 | 1.36 % |
| Money market | 14,709 | 177 | 1.21 % | 23,769 | 527 | 2.22 % |
| Savings | 169,541 | 2,759 | 1.63 % | 85,707 | 2,350 | 2.74 % |
| Time | 101,565 | 2,803 | 2.76 % | 127,475 | 5,071 | 3.98 % |
| Total interest bearing deposits | 343,743 | 6,321 | 1.84 % | 295,829 | 8,746 | 2.96 % |
| Borrowed funds | 33,139 | 1,426 | 4.30 % | 35,971 | 1,507 | 4.19 % |
| Junior subordinated debentures | 12,887 | 306 | 2.38 % | 12,887 | 590 | 4.57 % |
| Total interest bearing liabilities | 389,769 | $8,053 | 2.07 % | 344,687 | $10,843 | 3.15 % |

| | | | | | | |
|---|---|---|---|---|---|---|
| Non-interest bearing liabilities: | | | | | | |
| Demand deposits | 38,154 | | | 39,303 | | |
| Other liabilities | 2,303 | | | 2,036 | | |
| Total non-interest bearing liabilities | 40,457 | | | 41,339 | | |
| Stockholders' equity | 33,390 | | | 33,699 | | |
| Total Liabilities and Stockholders' Equity | $463,616 | | | $419,725 | | |
| | | | | | | |
| Net Interest Income and Margin (5) | | $15,585 | 3.60 % | | $12,292 | 3.12 % |

(1) Includes loan fee income
(2) Average rates on securities are calculated on amortized costs
(3) Full taxable equivalent basis, using a 39% effective tax rate and adjusted for TEFRA (Tax and Equity Fiscal Responsibility Act) interest expense disallowance
(4) Loans outstanding include non-accrual loans
(5) Represents the difference between interest earned and interest paid, divided by average total interest-earning assets

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Net Interest Income. Net interest income is the difference between interest and fees on loans and other interest-earning assets and interest paid on interest-bearing liabilities. Changes in volume and mix of interest-earning assets and the interest-bearing liabilities that support those assets, as well as changing interest rates when differences exist in repricing dates of assets and liabilities, directly affect net interest income.

Net interest income, on a fully taxable equivalent basis (a 39% tax rate), increased $3.3 million, or 26.8%, to $15.6 million for the year ended December 31, 2009 compared to $12.3 million in 2008. Total interest income, on a fully taxable equivalent basis, increased $500 thousand to $23.6 million in 2009 compared to $23.1 million in 2008. Our total interest income reflects a net increase in the volume of interest earning assets, offset by a net decrease in the average rate earned on those assets. Total average earning assets increased by $39.6 million to $433.1 million from $393.5 million for the year ended December 31, 2008. The average rate earned on total earning assets declined 42 basis points to 5.46% in 2009 from 5.88% for 2008.

Interest expense decreased by $2.7 million to $8.1 million for the year ended December 31, 2009 from $10.8 million for the year ago period as a result of decreases in market rates of interest. The average balance of interest bearing liabilities increased $45.1 million, to $389.8 million for the year ended December 31, 2009 from $344.7 million the year earlier. The average rate paid on interest bearing liabilities decreased 108 basis points to 2.07% for the current year from 3.15% for the year ended December 31, 2008.

The net interest margin increased, on a fully taxable equivalent basis, by 48 basis points to 3.60% in the year ended December 31, 2009 compared to 3.12% for the same period in 2008.

The decrease in rate earned on earning assets and the decrease in rate paid on interest bearing liabilities reflects the declining rate environment, as Federal Reserve rate cuts implemented to stimulate the economy have resulted in lower market rates on credit. In addition, higher non-accrual loan balances in 2009 compared to 2008 negatively impacted the yield earned on earning assets in 2009.

Interest Income. Total interest income, on a fully taxable equivalent basis, increased to $23.6 million for the year ended December 31, 2009 compared to $23.1 million for the year ended December 31, 2008. Interest income from the securities portfolio increased by $610 thousand and interest income from the loan portfolio increased by $109 thousand, offset by a decline in interest income of $216 thousand in other interest-earning assets.

Total interest income on the loan portfolio increased by $109 thousand to $19.3 million for the current year from $19.2 million in 2008. Although the average balance in the loan portfolio increased $18.9 million, or 6.1%, for the year ended December 31, 2009 compared to the year ended December 31, 2008, the average rate earned on loans decreased 33 basis points to 5.89% for the year ended December 31, 2009 from 6.22% for the same period in 2008. This is the result of non-accrual loan balances increasing $7.4 million during the year ended December 31, 2009 from the prior year end and lower market rates of interest.

Total interest income on securities, on a fully taxable equivalent basis, increased $610 thousand, or 16.4%, from the year ended December 31, 2008 to the same period in 2009, while the average balance of securities increased $16.2 million over the same two periods. The average rate decreased 28 basis points, from 5.25% in 2008 to 4.97% for 2009. The yield on taxable securities declined 42 basis points to 4.38% in 2009 from 4.80%, a year earlier as the average balance in taxable securities increased $11.8 million. On a tax equivalent basis the yield on tax exempt securities increased 7 basis points to 6.22% in 2009 from 6.15% a year earlier, as the average balance in tax exempt securities increased $4.4 million between the two years.

Interest Expense. The Company’s interest expense for the year ended December 31, 2009 decreased $2.7 million, or 25.7%, to $8.1 million from $10.8 million for the same period in 2008, as the average balance in interest-bearing

liabilities increased $45.1 million, or 13.1%, to $389.8 million from $344.7 million between the two periods. The average rate paid on total interest-bearing liabilities decreased by 108 basis points from 3.15% for the year ended December 31, 2008 to 2.07% for the same period in 2009. The decrease in interest expense reflects a decline in current market rates of interest and the Company's continued promotion of a highly competitive savings product yielding lower average rates of interest compared to time deposits.

The promotion of the savings account product, which began in the first quarter of 2008, has changed the Company's average balance breakdown between products. Time deposits, which represented 43 percent of total interest-bearing deposits in 2008, have been surpassed by average savings deposits in 2009, which now account for 49 percent of the average interest-bearing deposit balances. The average balance in savings accounts increased $83.8 million, or 97.8%, to $169.5 million for the year ended December 31, 2009 from $85.7 million for the same period in 2008, as

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the average rate paid on those deposits decreased 111 basis points to 1.63% for the year ended December 31, 2009 from 2.74% for the year ended December 31, 2008 following declining market rate of interest trends.

The average balance of time deposits has decreased by $25.9 million, or 20.3%, to $101.6 million for the year ended December 31, 2009 compared to $127.5 million the prior year. The average rate paid on time deposits decreased 122 basis points from 3.98% for the period ended December 31, 2008 to 2.76% for the same period in 2009. The average balance in money market accounts has decreased $9.1 million, or 38.1%, to $14.7 million for the year ended December 31, 2009 from $23.8 million for the same period in 2008. The average rate paid on money market deposits decreased 101 basis points from 2.22% to 1.21% between year end 2008 and year end 2009.

The average balance in the Company's borrowed funds decreased $2.8 million, or 7.9%, to $33.1 million in the year ended December 31, 2009 as a $3.0 million nine month repurchase agreement bearing an interest rate of 2.21% matured in December of 2008. At December 31, 2009, the Company's borrowed funds consisted of six convertible notes and one amortizing advance from the Federal Home Loan Bank. The interest expense on borrowed funds decreased $81 thousand to $1.4 million for the year ended December 31, 2009 from $1.5 million for the same period in 2008, while the average rate paid on borrowed funds increased 11 basis points to 4.30% for the year 2009 from 4.19% in 2008.

The Company's average balance in junior subordinated debentures remained unchanged at $12.9 million for the year ended December 31, 2009 and 2008. The interest rate paid on the debentures, which is tied to the three month LIBOR, resets quarterly and averaged 2.38% for the year ended December 31, 2009, a decline of 219 basis points from the average rate paid in 2008 of 4.57%.

The following table reflects the impact on net interest income of changes in the volume of earning assets and interest bearing liabilities and changes in rates earned and paid by the Company on such assets and liabilities. For purposes of this table, nonaccrual loans have been included in the average loan balance. Changes due to both volume and rate have been allocated in proportion to the relationship of the dollar amount change in each.

| | December 31, 2009 v. 2008 Increase (decrease) Due to changes in: | | |
|---|---|---|---|
| (Dollars in thousands) | Volume | Rate | Total |
| Securities: | | | |
| Tax exempt | $ 272 | $ 17 | $ 289 |
| Taxable | 491 | (170) | 321 |
| Total securities (1) | 763 | (153) | 610 |
| Total loans receivable (2) | 1,142 | (1,033) | 109 |
| Other interest-earning assets | 61 | (277) | (216) |
| Total net change in income on interest-earning assets | 1,966 | (1,463) | 503 |
| Interest bearing deposits: | | | |
| NOW | (13) | (203) | (216) |
| Money Market | (159) | (191) | (350) |
| Savings | 1,639 | (1,230) | 409 |
| Time | (905) | (1,363) | (2,268) |
| Interest bearing deposits | 562 | (2,987) | (2,425) |
| Borrowed funds | (121) | 40 | (81) |
| Junior subordinated debentures | - | (284) | (284) |
| | 441 | (3,231) | (2,790) |

| | | | |
|---|---|---|---|
| Total net change in expense on interest-bearing liabilities | | | |
| Change in net interest income | $ 1,525 | $ 1,768 | $ 3,293 |

(1) Fully taxable equivalent basis, using 39% effective tax rate and adjusted for TEFRA (Tax and Equity Fiscal Responsibility Act) interest expense disallowance.

(2) Includes loan fee income

Provision for Loan Losses. The provision for loan losses in 2009 was $3.4 million compared to a provision of $1.4 million in 2008, an increase of $2.0 million. The increase in the provision is primarily attributable to an increase in non-performing loans, which is due to adverse economic conditions and declining real estate collateral values in the Company's trade area. As a result of these conditions, the Company's non-performing loan balance increased to $20.4 million at December 31, 2009 from $11.0 million at December 31, 2008. The Company believes these loans are adequately provided for in its loan loss provision or are sufficiently collateralized at December 31, 2009. The provision for loan losses reflects management's judgment concerning the risks inherent in the Company's existing loan portfolio and the size of the allowance necessary to absorb the risks, as well as the activity in the allowance

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during the periods. Management reviews the adequacy of its allowance on an ongoing basis and will provide additional provisions, as management may deem necessary.

Non-Interest Income. The Company's non-interest income increased by $3.5 million to $5.5 million for the year ended December 31, 2009 from $2.0 million for the same period in 2008. The increase is primarily attributable to the absence of impairment charges in 2009, while the Company incurred an other-than-temporary impairment charge on equity securities of $3.5 million in connection with certain Fannie Mae and Freddie Mac perpetual preferred stock in 2008. The Company's non-interest income is primarily generated through insurance commissions earned through the operation of Tri-State and service charges on deposit accounts. The Company incurred decreases in both of these areas as service charges on deposit account income decreased $67 thousand, or 4.4%, to $1.5 million in 2009 and insurance commissions decreased $223 thousand, or 8.9%, to $2.3 million for the year ended December 31, 2009 from $2.5 million for the same period in 2008. Holding gains on trading securities also declined by $194 thousand to $5 thousand for the year ended December 31, 2009 from $199 thousand one year earlier. Offsetting these decreases, gains on the sale of premises and equipment increased $206 thousand, to $203 thousand for the year ended December 31, 2009 compared to a loss of $3 thousand for the year ended December 31, 2008 and gains on the sale of foreclosed real estate increased $248 thousand between the same two periods. Non-interest income from SussexMortgage.com for the year ended December 31, 2009 was $102 thousand as compared to $111 thousand a year earlier and is included in other non-interest income.

Non-Interest Expense. Total non-interest expense increased $90 thousand, or 0.6%, from $14.6 million in 2008 to $14.7 million in 2009. The Company has made several cost reductions to minimize the effects of the current economic climate by reducing its controllable expenses. Efficiencies were gained by decreases in salaries and employee benefits, inclusive of a $328 thousand accrual for a former executive's severance, of $194 thousand, or 2.6%. Furniture, fixtures and data processing expenses have decreased $195 thousand, or 13.2%, in 2009 over 2008 as the expiration of depreciable asset lives have been greater than replacement purchases. Advertising and promotion expenses decreased $290 thousand, or 61.8%, in 2009 compared to the same period in 2008 as the Company has reduced its agency-based marketing program. Professional fees increased $147 thousand to $768 thousand for the year ended December 31, 2009. This increase is substantially related to the Company's non-performing assets. Asset quality deterioration also contributed to an increase of $19 thousand in expense for the write-down of foreclosed real estate and $92 thousand in expenses related to the foreclosed properties. The write-downs are due to the decline in fair value of these foreclosed properties, and the additional expense is related to the ongoing cost to maintain those foreclosed properties held by the Bank. During 2009, our expense for FDIC deposit insurance premiums increased by $551 thousand, due to a one time special assessment of $211 thousand and higher assessments rates applicable to all insured institutions in 2009.

Income Taxes. The Company's provision for income taxes was $452 thousand for the year ended December 31, 2009, while the Company recognized a tax benefit of $1.1 million for the year ended December 31, 2008. The tax benefit in 2008 was attributable to the loss of Fannie Mae and Freddie Mac perpetual preferred stock being recognized as an ordinary loss, rather than a capital loss.

COMPARISION OF FINANCIAL CONDITION AT YEAR-END DECEMBER 31, 2009 AND 2008

At December 31, 2009, the Company had total assets of $454.8 million compared to total assets of $440.6 million at December 31, 2008, an increase of $14.2 million, or 3.2%. Net loans increased $12.4 million, or 3.9%, to $327.5 million at December 31, 2009 from $315.1 million at December 31, 2008. Total deposits increased to $372.1 million at December 31, 2009 from $360.1 million at December 31, 2008.

Cash and Cash Equivalents. The Company's cash and cash equivalents increased by $2.2 million or 10.4%, at December 31, 2009 to $23.1 million from $20.9 million at December 31, 2008. This increase reflects the Company's increase in federal funds sold of $1.0 million to $14.3 million at December 31, 2009 from $13.3 million at year-end 2008. In addition, cash and due from banks increased $1.2 million to $8.8 million at December 31, 2009 from $7.6 million one year earlier.

Trading Securities and Securities Portfolio. The Company's securities portfolio is designed to provide interest income, including tax-exempt income, and also provide a source of liquidity, diversify the earning assets portfolio, allow for management of interest rate risk, and provide collateral for public fund deposits and borrowings. Securities are classified as either trading securities or available for sale securities. The portfolio is composed primarily of obligations of U.S. Government agencies and government sponsored entities, including collateralized mortgage obligations issued by such agencies and entities, and tax-exempt municipal bonds.

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The Company periodically conducts reviews to evaluate whether unrealized losses on its investment securities portfolio are deemed temporarily impaired or whether an other-than-temporary impairment has occurred. Various inputs to economic models are used to determine if an unrealized loss is other-than-temporary. All of the Company's debt and equity securities have been evaluated as of December 31, 2009 and the Company does not consider any security impaired. The Company evaluated the prospects of the issuers in relation to the severity and the duration of the unrealized losses. The Company's securities in unrealized loss positions are mostly driven by wider credit spreads and changes in interest rates. Based on that evaluation the Company does not intend to sell any security in an unrealized loss position, and it is more likely than not that the Company will not have to sell any of its securities before recovery of its cost basis.

All securities are classified as trading securities or available for sale securities and are stated at fair value. Trading securities are recorded at fair value with changes in fair value included in earnings. Unrealized gains and losses on securities available for sale are excluded from results of operations, and are reported as a separate component of stockholders' equity net of taxes. Securities classified as available for sale include securities that may be sold in response to changes in interest rates, changes in prepayment risk, the need to increase regulatory capital or other similar requirements. The Company has no securities classified as held to maturity. Management determines the appropriate classification of securities at the time of purchase.

The following table shows the carrying value of the Company's available for sale security portfolio as of December 31, 2009, 2008 and 2007. Securities available for sale are stated at their fair value.

| | December 31, | | |
|---|---|---|---|
| (Dollars in thousands) | 2009 | 2008 | 2007 |
| U.S. Government agencies | $ 15,002 | $ 7,963 | $ 6,740 |